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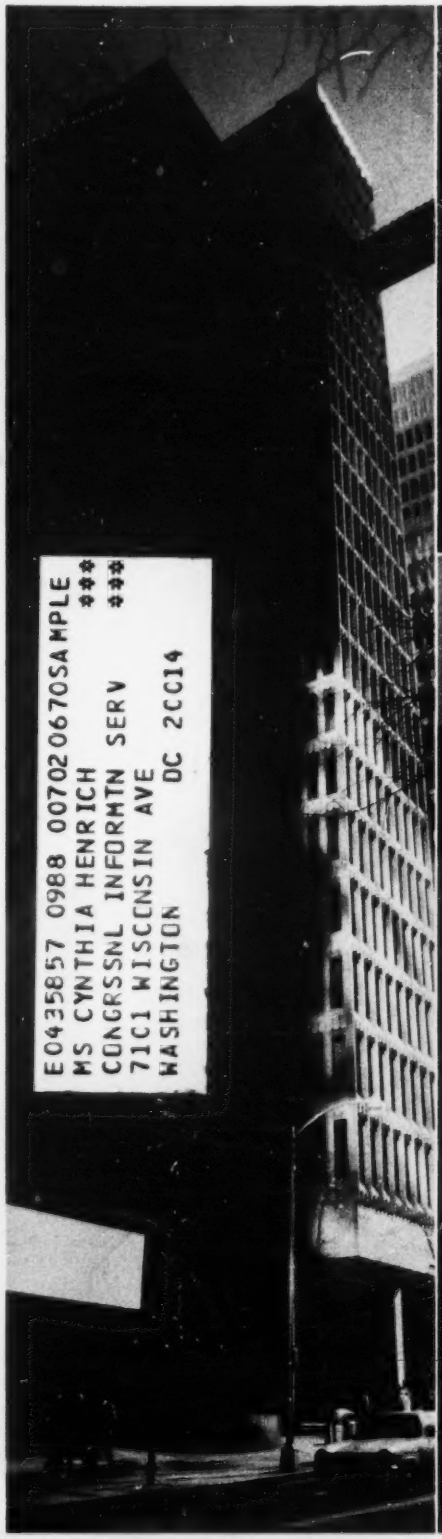

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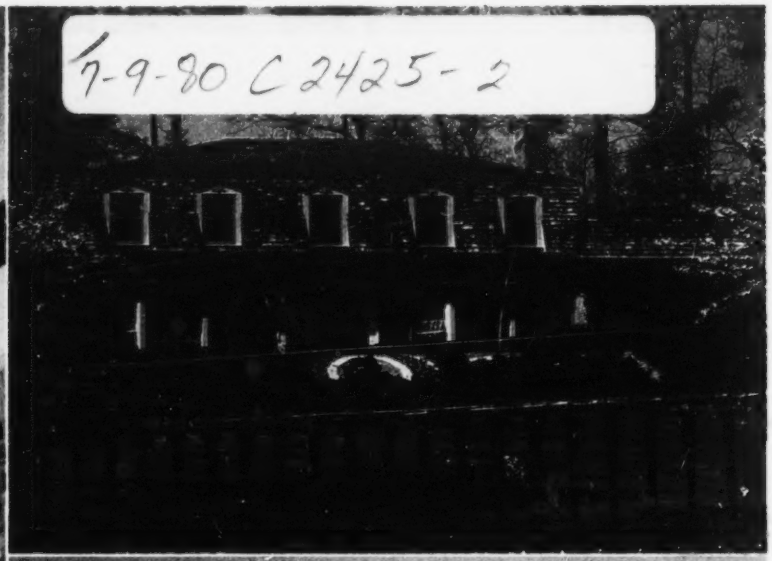

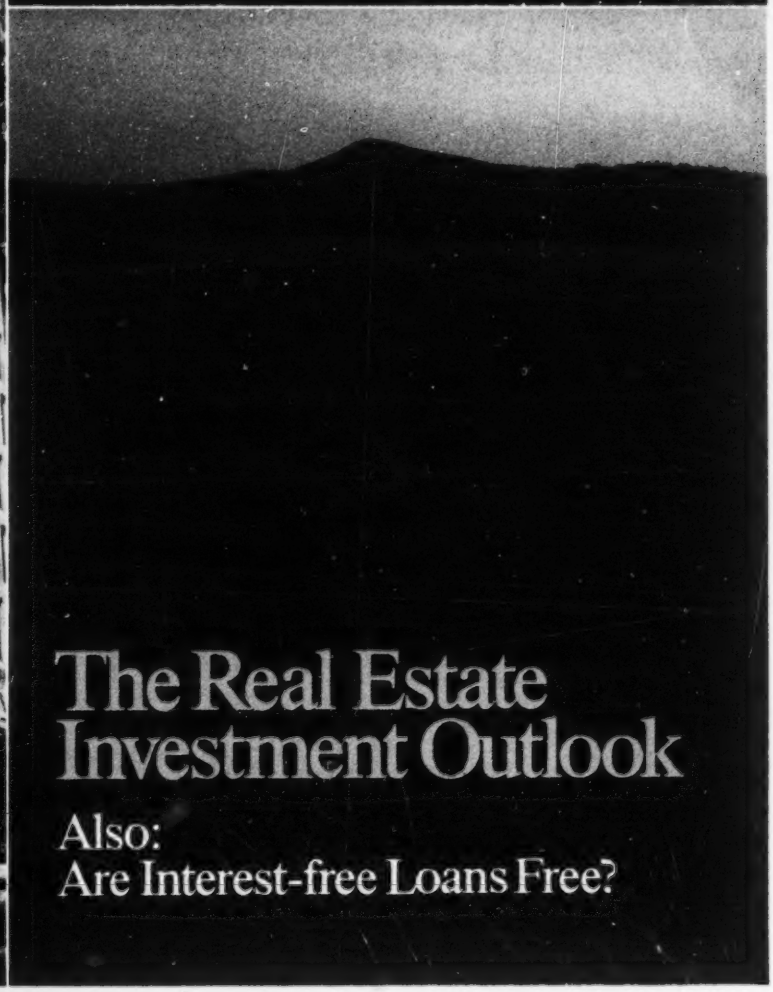

The Real Estate Investment Outlook

Also:
Are Interest-free Loans Free?

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COVER

Pictured on this month's cover are types of real estate with which trust departments may find themselves involved, either as an investment or as part of estate administration. Commercial property is exemplified by Atlanta's Peachtree Center. Our examples of agricultural and residential property were photographed by Bill Coker.

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Treating the Body Economic:

Thoughts on Interest Rates, Price Inflation, and Security Values

The cure is long and painful, but, according to the author, the time has come to take our medicine

by **JULES BACKMAN**
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Interest rates have risen to record levels as a result of virulent price inflation. These higher interest rates have had a major impact on security values and upon some areas of the economy. To help bring inflation under control, the Federal Reserve Board has moved vigorously to control the supply of money.

Can the Fed control inflation by monetary policy alone? Will increased productivity provide the solution? To what extent is the price inflation caused by higher energy prices? How will high interest rates affect financial markets?

Federal Reserve Policy

The change in Federal Reserve monetary policy announced October 6, 1979, represented a watershed development, namely the shift in emphasis from stabilizing interest rates to control of bank reserves.

Under its former policy, the Fed continued to provide the reserves required to meet its interest rate targets. During a period of rising inflation and inflationary expectations, higher interest rates did not provide a deterrent to borrowing by business and consumers as the record amply demonstrates. By controlling increases in reserves, there is a limit to the volume of credit available, and this forces interest rates higher — at least in the short term.

This policy has had an immediate significant impact on housing and to some extent on consumer borrowing. Marginal projects for new business investment have been shelved. Less money is available to finance the takeover of companies and for speculation in stocks and in commodities.

On March 14, 1980, the Federal Reserve, as part of President Carter's anti-inflation program announced a number of new credit restrictions. These included the requirement that large commercial banks borrowing from the Fed are to pay a surcharge of 3 percentage points above the current 13% discount rate, for a total of 16%. (This was eliminated in May.) In addition, institutions granting credit were required to freeze 15% of new credit extended into a Federal Reserve account. A similar provision is applicable to money market funds. This was reduced to 7.5% in May. Banks voluntarily are to increase new lending by no more than 9% and hopefully less as well as to discourage unsecured consumer loans and others. Further, marginal reserve requirements on managed liabilities (such as large CDs) were

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raised from 8% to 10% and then cut to 5% in May and the base on which such reserve requirements were imposed will be reduced by at least 7%.

But all of these measures will not eliminate price inflation, which probably can be expected to continue at an inordinately high level. Other factors contributing to the high inflation rate include the large federal budgetary deficit, the large rise in unit labor costs, and to some extent the continuing rise in oil prices. There is no indication yet that these pressures are abating. However, the March 14 statement of President Carter pledged a balanced budget for fiscal 1981. Congress subsequently agreed upon a 1980-81 budget, which was precariously in balance.

Table I

Percent Changes in Consumer Price Index and Unit Labor Costs, 1950-1979

	Percent Change in CPI	Percent Change in ULC in Nonfarm Business Sector
1950-55	2.15%	3.10%
1955-60	2.03	3.00
1960-65	1.28	0.03
1965-70	4.24	4.84
1971	4.30	3.56
1972	3.30	2.78
1973	6.23	5.97
1974	10.97	12.61
1975	9.14	7.87
1976	5.77	4.70
1977	6.45	6.32
1978	7.66	8.11
1979	11.26	10.23

Role of Productivity

A myth widely propagated is that increased productivity can contribute significantly to a solution of the inflation problem. Productivity or output per manhour (OPM) affects price inflation by its relationship to change in total labor compensation (wages plus social security taxes plus other fringes). When labor compensation grows more rapidly than OPM, there is pressure for higher prices.

Throughout the late 1960s and 1970s, unit labor costs have risen every year in the nonfarm private business sector of the economy. And the increases have been similar for the Consumer Price Index. (See Table I above.)

Against this background, several facts must be emphasized. The long-term rate of increase in OPM has averaged about 2.4% annually. Since 1974, OPM has increased an average of about 1% annually. In the past year, it declined by about 1%. The emphasis upon increased productivity is based on the hope that we can return to the long-term level of 2.4%.

It may be seriously questioned whether such a goal can be readily achieved in the near future. With a sluggish or recessionary economy, there is little probability that OPM will rise significantly in 1980 since the trend of business volume plays a significant role in short-term trends of OPM.

But assume that OPM does increase to about 2%. What is the probability that increases in annual labor compensation will be reduced from the current rate of 9% to that level? The answer is zero. A major factor in labor negotiations is the rise in living costs during the existing contract. This means that double-digit inflation in 1979 will be the most important single factor determining increases in labor compensation in 1980.

With little change in OPM and continuing large increases in labor compensation, there will be little or no diminution of pressure on prices from higher unit labor costs in 1980. And the 1980 price experience will set the stage for a repeat performance in 1981.

Clearly, increases in OPM, while desirable to raise the level of living, can play only a minor and unimportant role in reducing the rate of price inflation.

In the past, the Fed has underwritten the large increases in labor costs by its expansionary monetary policy. This support has been modified by its new policy. However, the required cutback in the size of labor cost increases will take a number of years to achieve because of the catchup to past increases in consumer prices.

Role of Energy Prices

Despite the widespread belief to the contrary, except in 1974 and 1979, energy prices have contributed only to a small extent to the ongoing price inflation in recent years. In 1978, energy prices (6.3%) actually rose less than all other consumer prices (7.8%). For the year 1979, energy prices advanced 25.2% in contrast to the increase of 10.0% for all other prices; the result was a hike of 11.3% in the CPI. Thus, we reached the double digit level of inflation without energy prices.

These data probably understate the influence of higher energy prices to some extent because they do not allow for the impact of higher energy costs on the prices of other products (e.g. chemicals) or the impact of a declining foreign exchange rate on the higher prices for imports.

Nevertheless, it is clear that even if energy prices were stabilized, it would eliminate only a small part of the underlying price inflation.

Higher Interest Rates and Inflation

Some critics have complained that higher interest rates contribute significantly to price inflation. This mixes up cause and effect. To the extent interest rates are a cost to business, they add to the pressures for higher prices. However, this is a minor factor for most companies.

Price inflation causes higher interest rates and not the reverse. Lenders be-

Table II

Changes in Consumer Price Index and Yields on Triple A Bonds

	% Increase CPI	Yields on AAA Bonds	Spread
1950-55	2.15%	3.00%	0.85%
1955-60	2.03	3.97	1.94
1960-65	1.28	4.37	3.09
1965-70	4.24	6.38	2.14
1970-73	4.60	7.35	2.75

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come increasingly reluctant to make loans and to be paid back in dollars of lower purchasing power.

Historically, the real rate of interest — that is, the excess of interest yield over the inflation rate — has averaged between 2% and 3%. This has been the experience for AAA bond yields, as Table II on page 47 shows:

When the inflation rate accelerated in 1974 and 1975, the real yield on AAA bonds became negative. In the 1976 and 1977 period, real yields once more became positive. However, in some months in 1978 and since February 1979, the monthly and three-month average inflation rate began to exceed the yields on AAA bonds with the *negative* real interest rate between 3% and 4%. (See Table III below.)

In the first three months of 1980, despite the sharp rise in yields on AAA bonds to an average of 12.14%, they were still lower than the inflation rate. In the first quarter of 1980, the CPI was 18.1% higher than a year earlier, and about 17% higher than in the preceding three months.

Investors have become increasingly concerned about price inflation and the erosion of the real values of their principal. If the rate of price inflation should decline to 9%, on the basis of past experience AAA bonds should sell to yield 11-12%.

Interest Rates and the Investor

A popular myth is that an interest rate equal to the inflation rate protects the bondholder against inflation. This may be true for one year, as can be easily illustrated. Assume an investment of $200,000 at 10%, a 10% inflation rate, and a level of living of $20,000 (including income taxes). The investor will earn $20,000 the first year and have living costs of $20,000. His living costs rise to $22,000 in the second year, to $24,200 in the third year, to $26,620 in the fourth year, and to $29,282 in the fifth year. Meanwhile, income is fixed at $20,000. Clearly, this family is in deep trouble.

Even if the investment income is not required for living and can be added to principal, there is no full protection. Income taxes will take a big bite from the interest earned. With a 50% tax (State and Federal), the total principal increases to only $210,000 or only by 5% after one year. However, its real value or purchasing power has been reduced to $190,909 ($210,000 ÷ 110%). In the second year, interest earned is $21,000, and $10,500 is added to principal for a total of $220,500. However, its real value is reduced to $182,231. Under these conditions, the purchasing power of the principal will be reduced by almost 5% a year. For those in higher tax brackets, the loss is greater, and for those in lower brackets, it is smaller.

When the inflation rate exceeds bond yields, the trends described are aggravated. In fact, even if bond yields exceed the inflation rate by 2% or 3%, there is a loss of real purchasing power after taxes at these levels of inflation. This is true both for those who must live on their investment income and those who do not.

Moreover, when interest rates rise to higher levels, the market value of debt securities and interest sensitive stocks,

Table III

Changes in Consumer Price Index and the Level of Triple A Bond Yields, 1978-80

	Consumer Price Index			
	Year-to-Year Change	Month-to-Month Change	Change in Preceding 3 months	Triple A Bonds
		[annual rate]		
Jan. 1978	6.79%	7.08%	5.84%	8.41%
Feb. 1978	6.38	7.68	6.48	8.47
Mar. 1978	6.51	8.88	7.96	8.47
Apr. 1978	6.63	10.80	9.20	8.56
May 1978	7.03	11.28	10.40	8.69
June 1978	7.43	12.36	11.60	8.76
July 1978	7.72	8.64	10.88	8.88
Aug. 1978	7.91	6.72	9.32	8.69
Sept 1976	8.32	9.12	8.20	8.69
Oct. 1978	8.89	9.60	8.56	8.89
Nov. 1978	8.95	6.60	8.48	9.03
Dec. 1978	9.03	5.40	7.24	9.16
Jan. 1979	9.35	10.68	7.56	9.25
Feb. 1979	9.93	14.04	10.08	9.26
Mar. 1979	10.17	11.64	12.24	9.37
Apr. 1979	10.44	13.80	13.28	9.38
May 1979	10.76	14.76	13.52	9.50
June 1979	10.91	14.04	14.36	9.29
July 1979	11.29	12.72	14.00	9.20
Aug. 1979	11.78	12.12	13.08	9.23
Sept 1979	12.09	12.48	12.56	9.44
Oct. 1979	12.20	10.80	11.88	10.13
Nov. 1979	12.62	11.16	11.56	10.76
Dec. 1979	13.31	12.60	11.64	10.74
Jan. 1980	13.92	17.28	13.84	11.09
Feb. 1980	14.15	16.44	15.64	12.38
Mar. 1980	14.68	17.28	17.24	12.96
Apr. 1980	14.66	13.56	15.96	12.04

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such as public utilities, may decline significantly. For example, AT&T 8.80s of 2005 fell from 97 in November 1978 to 94½ in May 1979, 83 in November 1979 and 70 in March 1980; they increased to 85 early in June. This development aggravates the problem for those who must sell capital assets to maintain their level of living.

The Stock Market

Higher interest rates generally are considered bearish for stocks for several reasons:

1. They result in attractive alternatives to investments in stocks as was shown by the high yields on short-term and long-term debt in the early part of 1980.

As an aside, the six-month savings certificates do not provide a very attractive alternative today. The rate paid on these savings certificates is the discount for six month T-bills in the previous week's auction. However, this discount is not the yield on the investment. Report of the T-bill auction shows two figures: (1) the discount and (2) the bond yield basis. In the March 17, 1980, auction, for example, the discount used by the banks was 14.950%, but the bond yield equivalent was 16.40% or 145 basis points higher. In the June 2 auctions, the discount was 8.17%, and the bond yield equivalent was 8.64% or 47 basis points higher.

Moreover, local income taxes also must be given consideration. For example, the interest on the savings certificate is subject to New York State and New York City taxes while the interest on T-bills is not. Assuming a 40% federal tax bracket, the net cost of the State tax in March 1980 was 8.4% or 125 basis points. Thus, the net after state and local tax yield on T-bills bought at that time was 16.4% as compared with 13.70% for the savings account, a difference of 270 basis points. This figure would be reduced by the cost of buying the T-bill if it is not bought directly from the U.S. Treasury. On June 2, 1980, the yield on T-bills was 8.64% compared with 7.48% after state taxes on the savings certificate, a difference of 116 basis points.

There is another factor against the savings certificates. You are locked in for six months, or you forfeit part of the interest. In contrast, the T-bill can be sold at any time without losing interest. However, the amount received will depend upon the trend of interest rates and selling costs.

2. Higher interest rates result in a lower market value for a given level of dividends, as the sharp decline in public utility stocks has demonstrated. This development also makes long-term bonds less attractive as an alternative to stocks. The decrease in value can be very large as was noted earlier.

3. High interest rates also make margin trading very unattractive. Brokers' loan rate of 20% in March 1980 exceeded by a wide margin the long-term gains experienced by stocks. Various studies have shown that, over the very long term, common stocks have yielded an average of about 9% from dividends and capital gains. True, in shorter periods the gains have been much larger, if you can catch the cyclical swing, e.g., 1978 to 1979. However, it is sobering to realize that to cover today's interest cost on margin accounts, the gain on stocks must be about double the long-term rate *to break even.*

Against this background, it is not surprising that the most important single factor determining the large advance in stocks from March 1980 lows was declining interest rates. For long-term interest rates to decline significantly, the basic requirement is a significant abatement of price inflation.

Low PE Ratios

Each day the stock tables show the price-earnings (PE) ratios of companies traded on the New York Stock Exchange and the Amex. Similarly, the PE ratio of the Dow Jones average is reported weekly. In June 1980 that ratio was about 6-7 times. These reported ratios are at relatively low levels. Does this mean that stock prices are cheap? I don't know.

However, I do know that, because of the ongoing price inflation, the reported PE ratios are meaningless for most companies. Why? Because they do not reflect the large overstatement of reported net profits after taxes resulting from inflation. For companies which do not report inventories on a LIFO basis, part of the alleged profits must be used to replace inventories at higher prices than charged to costs. Similarly, in determining costs, depreciation is charged off on the basis of original cost so that part of the reported net profit must be used to finance higher cost replacements.

How large is the overstatement of reported net profits after taxes? Overall data are available for non-financial business. In 1979, the totals were as follows:

	Billions
Net profits after tax	$115.5
Inventory valuation adjustment	−41.9
Capital consumption adjustment	−15.6
Net profits after inflation adjustment	58.0
Dividends	47.2
Undistributed profits, adjusted	10.8

Net profits after adjustment for replacement costs of inventories and plant and equipment were only 50% of the reported total.

In 1979, the Dow Jones average PE ratio based on reported profits averaged about 6 times. If the adjusted earnings were used for the calculation, it would have been about 12 times.

The approximate data for inflation adjusted earnings for major companies are now reported in their annual reports in accordance with Statement of Financial Accounting Standards No. 33. The extent to which reported 1979 earnings would be adjusted downward may be illustrated for IBM and General Electric. (See Table IV at top of page.)

Obviously, these numbers do not tell the entire story because inflation also has increased the value of a company's property and hence the net worth of

Table 1[1]

Inflation-adjusted Earnings, 1979

	IBM	General Electric
Reported Earnings Per Share	$ 5.16	$ 6.20
Earnings Adjusted for General Inflation	3.85	4.66
Stock Price — March 19, 1980	59.00	47.00
PE Ratio — as Reported	11.4X	7.6X
PE Ratio on Adjusted Earnings	15.3X	10.0X

Sources: *Annual Reports 1979*, IBM, p. 34 and General Electric, p. 29.

most companies. Nevertheless, they do indicate the importance of looking behind the reported numbers in making investment decisions.

Conclusions

Price inflation is the most significant factor affecting the economy and financial markets. The distortions created affect business planning, economic activity, and economic values. Traditional measuring sticks lose their significance and the financial ship flounders on uncharted seas.

Inflation is a drug which infects all parts of the body economic. Withdrawal from any drug addiction inevitably is painful. Similarly, there is no easy way to end price inflation, but the price of withdrawal must be paid. The longer we wait, the greater the pain.

The elimination of price inflation will unavoidably adversely affect economic activity and be accompanied by greater unemployment. But the real choice is some unemployment now or much greater unemployment later as the inflation seriously impairs the effective functioning of the economy. When you go out on a binge, you can't avoid the morning after. Neither can the economy. □

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Dr. Backman has written more than 100 books and pamphlets and has contributed many articles to economic periodicals and trade journals, including TRUSTS & ESTATES. Among his writings are "Wage Determination," "The Economics of the Electrical Machinery Industry," "The Economics of the Chemical Industry," "Advertising and Competition," and "Inflation and the Price Indexes." He was formerly an editorial writer for *The New York Times.*

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